DOCUMENT RESUME

ED 036 994 EF 000 671

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TITLE Developing Practices Concerning General Obligation School Bonds and Capital Outlay Financing.
PUB DATE Oct 64
NOTE 11p.; Paper presented at the Annual Meeting of the Association of School Business Officials (50th, San Francisco, California, 17-22 October, 1964)

EDRS PRICE EDRS Price MF-$0.25 HC-$0.65
DESCRIPTORS *Bond Issues, *Educational Finance, Financial Needs, *Financial Support, School Support, *State Federal Aid

ABSTRACT

A review is presented of the history and evolution of general obligation school bonds and capital outlay financing for public education. Following a discussion of past legislation of several states concerned with school borrowing, the evolution of school bonding is explained in terms of increased school financing from 1900 through 1958. Consideration is given to the school building authority, federal aid, and state capital outlay assistance as major causes for the plateau in school borrowing. The rate of expansion of building authority bonds and state bonds is also considered. (FS)

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The attentive audience at the General Obligation School Bonds Section Meeting on Monday afternoon listening to the presentation of Emmett Shockley, the speaker at the podium.

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DEVELOPING PRACTICES CONCERNING GENERAL OBLIGATION SCHOOL BONDS AND CAPITAL OUTLAY FINANCING

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Introduction. Your attention first should be called to an examination of the title of this presentation in order to clarify its meaning and eliminate any misconceptions about it which you might have. You will note that it really is two parts – developing practices concerning general obligation school bonds, and then developing practices concerning capital outlay financing.

It is not my purpose to give you two presentations, however, so perhaps it would be better to think of the main line of thought here today as an examination of the relationships between the two, and since school bonding must play a subordinate role to capital outlay financing, we actually will be examining what it is that changing patterns of the latter are doing to the former, their traditional source of cash. The comparison should be pertinent, because about 80 percent of capital outlay income is going for debt service, and new types of programs and new sources of income may bypass borrowing and decrease its contribution.

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From the beginning, revenue programs for building buildings have been in for rough sledding. You are aware, I am sure, of the notable omission by the farmers of our Constitution of specific reference to education. The somewhat belated appearance of a comment on the value of education in later years in the Northwest Ordinance perhaps was apologetic in this respect, but still the burden of education was placed from the beginning upon the various states, and perhaps rightly so. The deep mystery which still seeks an adequate answer is why the states assumed responsibility for education but abrogated any rights they may have inherited concerning the financing of this program. Almost continually one hears reference to our forefathers as being intensely interested in education. Now it is true that there were certain leaders who fought for support of public education, but they had no popular backing. It is true that aristocrat and commoner alike seemed to be genuinely interested in raising the level of the commoner, but historical fact shows that the interest generated mostly talk – that when the problem of paying for the dreams arose, there was a good buck passing session until it got all the way down the line to the parents. Even when state legislatures were forced to assume some obligation because of urbanization, rate bills taxing parents were continued, and those who applied for free schooling were stigmatized in the social order.

But it is not the purpose of this presentation to go into detail over the fight which occurred early in the 19th century to get states to accept some financial responsibility for a program over which they exercised legal control. State aid did develop slowly in reference to operating expenses, but almost not at all in reference to capital outlay.

I. *Early Developments.* It is true that early school finance did not differentiate between operating expense and permanent improvements, but as crude as their system may have been, they still understood the differences between paying teachers a salary and building a place for them to teach, and when state aid began shortly after the War of 1812, the money first was used to get teacher pay on a cash basis and out of the role as recipient of the varied produce of the agricultural enterprises of the area.

I would say that the lack of capital outlay assistance from the state level then was due very much to the same reason it is lagging at present. There wasn't enough for current expenses, so capital outlay was disregarded.

An early volume of the annual report of the U. S. Commissioner of Education has an interesting description of the typical process in the early 19th century:

"On the appearance of the wandering pedagogue, the families interested, after satisfying themselves of his character and capacity, built a log or frame schoolhouse as near the center of the school community as possible; furnished it according to the rough and ready fashion of the day, and placed therein the master to work out his salvation, often in fear and trembling. He was the guide, philosopher, and 'friend' of the group of boys and girls intrusted to his charge. Now the college and the academy, except the State university and an occasional private, corporate, or family organization, were of the denomi-

national religious order, generally under the control of the distinctively ecclesiastical authorities, often taught by clergymen and churchmen and almost entirely removed from popular influence or supervision. But here, with no such combination, the people kept their own hands on the entire arrangement. They built the schoolhouse, hired the teacher, furnished the children, paid the bills, and left the big boys to decide on the necessity of holidays."

It is apparent that early capital outlay financing involved no general obligation school bonds. There may have been borrowing for school construction, but it was the action of a group of enterprising parents and not a governmental organization. Everywhere it seemed that there was so much difficulty obtaining adequate funds to run schools there was little left for building any. Income from school lands came and went providing little assistance. Several southern states inaugurated, and some still have, special accounts called Literary Funds which were for providing a source of cash for schools, but they and similar programs could produce only a fraction of what was needed.

The most promising practices of early lawmakers centered around their earmarking of taxes and reserve funds specifically for school buildings. Maryland in 1825 may have been the first state to pass a law assessing an ad valorem property tax for a school building fund. But it was so unpopular that it was repealed three years later. South Carolina was successful in passing but not enforcing a similar law in 1852. One year later, an Ohio law levied one-tenth of a mill on the property assessments in the state, the income to be distributed for school buildings on a census basis. Minnesota tried in 1859; Delaware followed in 1861. In most of these and other situations, the intent was there but the money seldom showed up in a quantity large enough to do any real good. There was little popular support behind these legislative actions. As as example, the new territory of New Mexico in 1855 passed in one of its early legislative sessions a school support bill which was so unpopular that a referendum was forced. The vote against the tax was 5,053 to 37.

II. *Early Borrowing.* It was in this atmosphere of haphazardous income from state lands, from gifts, from rate bills, and from fickle property tax levies that borrowing became the accepted method of providing for school building costs. Shunned at first, except by a few more enterprising communities, it became increasingly popular after the Civil War.

It was popular, that is, with school officials, but financial writers worked hard against it. The depression of the 1870's slowed down bonding and aided greatly in getting into state constitutions debt limitation provisions. It wasn't until after World War I that leaders in educational finance stopped pushing pay-as-you-go and began recommending debt through bonding for construction. Now there is nothing wrong with pay-as-you-go. It is wonderful! Any time you can get the job done without going into debt, it is ideal. But economic reality simply does not allow new buildings and improvements from current revenue.

One of the most persistent early arguments against school bonding was in the *productive enterprise* concept. As school bonding became more popular in the late 19th century, opposition developed and pushed the argument

that safe and sane borrowing should be allowed only for the purpose of productive enterprise. Productive enterprise was defined as one which produced wealth with which to repay the loan. Non-productive enterprise was characterized more or less as a rathole through which money would be poured and the loan repayment then would have to come from a levy against tax-paying productive enterprise. This levy was characterized as being so burdensome to productive enterprises paying it that their effectiveness was reduced, thereby stifling the entire capitalistic system. I believe we all see the fallacy of this theory which is being disproved most assuredly right here in the state of California with its magnificent educational program. Educational enterprise is *not* non-productive because it produces greater skills and tools and more ultimate efficiency so that enterprise merely is exercising a good old capitalistic maxim when it pays taxes for education —it is plowing back some of the profits into plant and product improvement which will in turn increase future profits.

Borrowing was the only feasible solution to the dilemma of lagging school construction, especially after the depression which followed the Civil War and the physical destruction which was caused by it.

The first borrowing of money for schoolhouse construction by a school district which was following the law probably was in New York. From 1845-49 special legislation was passed allowing four different school districts or their trustees to borrow money and pledge the full faith and credit of the taxpayers of the district as security for the loans.

From this inauspicious beginning, a total of 167 special acts authoizing bond issues marched through the legislature of that state from 1850 to 1927 when general laws covering bonding rendered such actions no longer necessary. Special acts such as those in New York went into considerable detail, specifying the amount of bonds that could be issued, the method of repayment including the tax levy against the property owners of the school district, the method of sale, the length of maturity, rates of interest allowed, bond denominations, and even such matters as who should sign the bonds and how they should be numbered.

Special legislation on education in general and school borrowing in particular in a large measure arose from the limited and inadequate character of general school laws and from the consequent failure of such general laws to provide for the problems which arose in the growth of schools and their building needs.

With few exceptions, general laws concerning school bonding were not passed until after the turn of the century. This is not true of constitutions, however. It simply showed that there appeared to be no need for them as educational expenditures were comparatively small and generally were paid from current taxes. If a school system, usually a large one, wanted authority to float an occasional bond issue and tax the patrons of the district to repay it, they simply took their case to the legislature.

Pennsylvania was an early exception. Fully one-third of the special school laws passed before 1873 were for borrowing and bonding, but the Constitution of that year abolished special bond legislation. Other state legisla-

tures, however, were not as quick to relinquish their practice of examining in detail each request for issuance of bonds by school districts. Ohio passed almost 1,500 special laws from 1850-1900, nearly one-third of which were related to the borrowing of money and the issuance of bonds by local school districts. Legal histories of North Carolina, Florida, and a dozen other states are full of such special laws.

III. *The Plateau in Current Bonding.* Today all states have general laws covering the issuance of general obligation bonds for schoolhouse construction, although the remnants of special legislative provisions still remain in some. The issuance of bonds in the 20th century has been tremendous compared with those sold before 1900 when it was a big year if all school bonds sold totaled more than a million dollars. But there has been a leveling off in the last ten years, and the question is raised as to the reasons for the plateau which has developed.

During the 1953-54 year, approximately 1.5 billion dollars was reported as issued in general obligation bonds for school construction. Slowly this yearly total crept up until it reached almost 2.5 billion for the 1957-58 year. Since that time it has fluctuated but generally has dropped, and the 1962-63 year was reported as showing issues in the amount of 1.8 billion dollars – only $300,000 more than ten years ago.

Certainly such immeasurable factors as voter antipathy and an easment of tensions which spawn additional classroom facilities could be considered. However, there are some interesting sidelights which parallel the recent trend in school bond issuance which may get us to our answer a bit sooner.

IV. *The School Building Authority.* The first but not necessarily the most important, is the rise of the holding company, most often represented by a school building authority. The relationship of this phenomenon to the somewhat static record of bonds issued in the past ten years is not clear, because holding company bonds are included in the totals quoted. But there is no doubt that it is replacing the general obligation bond and the red tape that goes with it, although some who have had experience with school building authorities inform me that red tape replaces red tape here. It was in 1949 that a Pennsylvania decision (Greenhalgh v. Woolworth 64 atl(2nd) 659) opened the gates for this new type of operation in that state. Other court decisions in other states followed the pattern, and the school building authority spread. It is difficult to say why the courts changed their thinking on this matter, but they did.

The operation of the building authority is a relatively simple one. Rather than issue bonds for school construction, school officials will lease a building from the authority, which uses these lease payments to redeem the bonds it issued to build the building. Of course, the authority is outside the regulations and limitations placed upon schools who would try to issue similar bonds. This type of program often is referred to as a rental revenue bond program. So effective has this practice been in Pennsylvania where passing and issuing general obligation school bonds is not nearly as difficult as it is in many other states, that total bond sales for public school purposes since the 1949

decision until January of this year have amounted to only 1.4 million dollars, while total building authority lease obligations went to almost 1.7 billion dollars.

Pennsylvania is not the only state with the building authority proviso, but it is the leader. Kentucky, Indiana, Georgia, and Maine have been some of the more active ones in the field, but the list of states with such laws inoperable at this time is quite long. Permissive legislation is there but there is no case law to assure the process as legal, and proposed authority bonds in these states are difficult to market. In New Mexico, for example, such a law was passed in 1957, but it has been dormant because there has been no indication that the law is not in violation of the state constitution. At this time, seven years later, a test case finally is being filed so the matter will be cleared up.

The legality of the school building authority appears to be getting stronger and clearer, in spite of three strong arguments against it. The first is that it is a subterfuge and that it allows a school district to go into debt beyond the limitation allowed by law. Another is that the school eventually gains title to the property which proves that the lease was not a rental but a purchase on the installment plan, a process which we all know from our experiences at home, creates debt. The third objection involves a practice in some but not all of the school authority laws where state assistance is provided to pay the lease amount. Most often the state will withhold certain state funds due the school district and will authorize the school district to levy a local tax to offset the amount withheld.

Various courts have rejected these arguments. In reference to the idea of going beyond the debt limitation to acquire property, the courts have said that if the school district's credit is not placed as security for the debt and the school is not liable if the authority defaults, then there is not a debt created for the school district. Furthermore, the courts have ruled that if a school should gain title to property after having paid this lease price for a number of years, it certainly is permissible, since the law refers to debt limitation and not to property acquisition. Should the school district find a way to obtain property without pledging the credit of the taxpayers as security, then it should not be restrained from doing so. The same general idea applies to the third objection voiced by taxpayers who are concerned about increased taxation. The law provides a limitation upon debt but not on the tax levy.

Although the courts have cleared the air considerably in this matter, the cold light of logic forces us to admit that the building authority probably violates the intent of the law. One cannot help but feel that it is something which is beyond the confines of the law as formulated in years past, and that if the imaginations of those who framed the legislation could have foreseen the advent of holding companies, there would have been specific prohibitions against them or against certain facets of their present-day operation.

But this emphasizes one of the advantages proponents claim for the authority type of financing. It allows schools to advance at a pace more in keeping with our modern society and certainly casts a shadow upon legislation which is so imbedded in tradition that change is almost impossible.

V. *The Federal Government.* To say that the federal government is reducing the need for general obligation school bonds at the district level seems to go against the actions of Congress in the past few sessions where federal aid to education has been kicked around plenty but not out, but it is true. The United States is pouring millions of dollars annually into thousands of schools throughout the country and a large proportion of this money is being used for capital outlay.

Through Public Laws 815 and 874, both of which receive new life with periodical appropriations by Congress, many school districts are building classrooms which ordinarily would have been covered by bonds. There appears to be little chance that federal aid will diminish, so this must continue to be considered a major factor in lessening the need for bonds at the local level. Whether this is good or bad is a philosophical point.

VI. *State Capital Outlay Assistance.* Probably the most important trend in recent years, however, is the increasing role of states in providing capital outlay assistance for schools just as assistance for current operating expenses have been provided for many years. In 1945, Florida began a capital outlay assistance program which started the ball rolling, and today about two-thirds of the states can point to some type of assistance provided for this type of endeavor. True, some of these programs are negligible or will shortchange operational cash if used, but the idea is growing.

The question arises about how much state aid should be for operational expense and how much for capital outlay. Experts disagree, but it is felt that going beyond 15 percent of the total for capital outlay will shortchange operational cash, and going below ten percent of the total will shortchange capital outlay. If this idea can be accepted, then we must cut the list of states providing a proper capital outlay assistance program to a handful.

Now all states do not have equalized state assistance programs, and the balance varies immensely. Of total non-federal revenue used by schools, some states such as Nebraska and Iowa provide less than 15 percent from the state, while Delaware, New Mexico, Alaska, and Hawaii schools receive more than 85 percent of their non-federal revenue from state sources. Obviously, a substantial state aid capital outlay program in one of the latter states mentioned is more productive than a similar program in Nebraska or Iowa.

Of course, when we talk of state support, it must be emphasized that this doesn't mean that the money comes from some magic chest within the legislative halls. It can easily come directly from local taxation, *but the tax is* levied and usually collected by the state. Sales tax generally is looked upon as a state tax because it is levied, collected, and then doled out by the state. But it is coming from the local pocketbook just as certainly as are ad valorem levies on property which so often are looked upon as a "local tax."

With total state aid percentages in mind, a brief listing of some of the more advanced programs would be in order. Vermont and New Hampshire provide 40 and 35 percent respectively of their state aid package for capital outlay – an amount that would be excessive if all the income for operational expense were coming from the state. Delaware and Massachusetts go over

20 percent, and Florida, New Jersey, Connecticut, and Maryland are above ten percent. Hawaii, which is not included, technically is 100 percent state aid as the legislature makes final authorization on all school apporpriations although towns and municipalities may initiate bond issues where needed for schools.

VII. *State Aid Distribution Processes.* How does this state aid get to schools? Two methods are paramount. The first is an outright grant based upon some distribution formula and sometimes requiring the local districts to exhibit some effort toward self help. The second is called a loan but really is a grant, with few exceptions, because the law which authorizes the loan authorizes the school district to repay the loan by levying additional taxes. Other programs are existent but only in one of these two forms mentioned is a school district going to derive any real state aid for capital outlay.

The most popular method of state assistance for permanent improvements is the project assistance program. When a school district begins construction, the state provides a percentage of the cost. Connecticut will go up to 50 percent; Delaware ranges from 60 to 100 percent. Vermont will provide up to 30 percent, while in Massachusetts it starts at 30 percent and can go as high as 60 percent.

Other states with similar programs are Washington, Rhode Island, Maine, Maryland, and New Jersey. Often benefits are extended if the school district provides matching funds or meets some other criterion.

The outright grant which is unrelated to specific construction projects but which is distributed instead as a part of a foundation program is popular in the South. In Florida, schools are given $400 per instructional unit, more if they will match locally. Alabama provides varying amounts, depending upon appropriations, the sums being made available on the basis of teacher units. Kentucky, more generous than the others, gives $600 outright per teacher unit. Georgia, Mississippi, and South Carolina provide outright grants based on attendance, but the funds are held in trust until they are needed to finance construction. In Mississippi, schools may withdraw not only funds due them but may borrow against the future. Michigan, certainly no Southerner, has a foundation program which sets aside five percent for capital outlay.

Other methods are rare and somewhat unique. New Hampshire gives an allowance only to school districts paying off bonds. Utah has money for districts which are bonded to capacity and still in need. Some states, as in Alaska, provide assistance with no strings attached, from special funds.

It should be emphasized that these descriptions do not cover the many dollars which find their way into capital outlay programs from current operating expense allocations, nor are emergency appropriations covered. Both can provide substantial assistance to school districts who happen to be in the right place at the right time.

The loan method, although it really isn't a loan, is not as popular as the grant, but it is more fruitful generally. California certainly leads the states in this field. A total of 1.5 billion dollars has been floated by issuance of state

bonds and loaned to school districts bonded to optimum capacity. Repayment is by special assessment of the property in the district, so it really isn't a loan – it is an opportunity to obtain income from an extra tax levy.

Others who do this in general but on a much smaller scale are Alabama with a 100 million dollar bond issue, Georgia with its school building authority, Indiana with its Veteran's Memorial School Construction Fund and Common School Fund, Pennsylvania with its school building authority, and several other programs in other states, many of them minor. Michigan qualifies for a blue ribbon for one of its loan programs. It allows local school districts to issue their own bonds, but after approving the bonds before issuance, which throws the full faith and credit of the state behind the issue at sale time. This should lower interest rates, but it is difficult to prove results at this point for Michigan's general obligation bond interest rates have been higher than the national average for several years, perhaps due to other factors.

Other states have loan programs which really are loans. School districts must pay back the amount borrowed from regular income without any increase in tax levies. Others have good programs but no appropriations to cover them, so they are inoperative at this time.

VIII. *The Picture on Authority Bonds.* We now have examined the three primary intrusions into the general obligation school bond market. All have developed since World War II, and all began about the same time. Modern types of state capital outlay assistance, federal aid, and school building authorities are no older than 15 years. Now it perhaps would be impertinent to make any predictions about the future with only 15 years of background to examine, but a look at current trends would not be out of line and might give some clues.

First of all, checking sources of school bond issues for the past five years shows us that the building authority bonds are the only ones which are rising steadily. In 1958-59 they comprised six percent of the total percentage of bonds issued by source. In the 1962-63 year this percentage had risen to 14 percent, more than doubling. What other sources dropped to make way for this gain? Well, school district issues and municipal or township issues for schools contributed to the gain by dropping in percentages. Bonds issued by school districts from 1958-60 averaged 66.6 percent of the total whereas the average from 1961-63 was only 61.6 percent. Municipal or township issues for school purposes dropped from 13.4 percent to 11.9 percent during the same period. State and county issuance of bonds for construction of classrooms remained fairly static.

Some items of interest should not be unnoticed. First, the number of states using authority bonds has remained about the same since the early fifties, but they haven't been the same states each year nor has the amount leveled off. In the past five years there have been only ten states in the authority finance picture. Pennsylvania, Indiana, and Kentucky, of course, have been the primary ones. All have recorded considerable authority activity each year for some time. Indeed, Kentucky authority sales have totaled almost 100 percent of all bond sales reported from that state. Others which

have gotten into the picture from time to time recently are California, Louisiana, Michigan, Texas, Georgia, Wisconsin, and Illinois.

Authority sales totaled only 170 million dollars in 1959-60 but rose to 318 million dollars in 1962-63. For the period from 1959-63, authority sales have totaled almost a billion dollars. I would say that authority financing is here to stay and certainly will continue to rise unless more realistic legislation makes bonding at the local level popular once again by raising debt limitations, equalizing assessment practices, and eliminating some of the more distasteful aspects of the referendum. To stray for a moment, let us examine this voting requirement. It seems to be something sacred, and most people are aghast at the thought of not having an opportunity to vote on school tax levies, yet they are taxed for other things by their legislature and they seem to have not such feelings. In the past six years, about one-third of school construction money from bonds was obtained without voter approval, and less than half of this was authority money. Fully 18 states today have various provisions whereby all bonds issued do not require a vote. Alabama and Hawaii have to vote on bond issues at all. Other states, such as Delaware, Florida, Indiana, and Kentucky have so few bond elections that voting for all practical purposes is non-existent.

The school building authority bonds are surprising in one respect. At this time it does not appear that there is any saving despite arguments by authority proponents to the contrary. Of 21 annual state authority reports over a five year span, only two showed interest rates lower on the average than other types of school bonds issued in the states concerned. To this interest rate must be charged the administrative costs of the authority before one can arrive at the true cost of authority financing. If this were offset, however, by the expense of bond campaigns, elections, attorneys, fiscal agents, and other expenses which normally fall upon a school district processing its own bond issue, perhaps the cost is not so much more after all.

IX. *The Picture on State Bonds.* State bonds have not shown the expansion that authority financing has. They developed primarily as the revenue source for the new capital outlay state aid programs, and their future is uncertain. There appears, certainly, to be no aggressive attempt from any quarter to have state issuance of bonds replace other sources of issue, although this might be one way to ease interest charges. Almost 80 percent of state school bonds issued since 1959 have drawn lower interest rates than those issued by other agencies. State bonds have been most popular in California, Delaware, Florida, Maryland, and South Carolina. In all of these states the purpose of issue was to provide grants for capital outlay programs.

X. *Conclusions.* Certainly it appears that it will be many decades before municipal general obligation school bonds disappear from the scene, but there is a distinct possibility that they will continue to lose ground to other more centralized sources of revenue. This would be in keeping with the increasing role of the state in providing capital outlay assistance.

The school building authority is a big question mark in this picture because its popularity can easily be enhanced or curtailed by legislative enact-

ments. If schools are allowed to make special tax levies to pay for the rentals, then the authority should continue to rise in popularity. Such a setup is nothing more than a disguised state grant, and the authority serves to define the process rather than change the philosophy of state aid.

Another question is – how far will school building authority influence spread before state legislatures choose to make direct grants to schools covered by an appropriation deriving its income from taxes formerly paid at the local level for local bonding programs?

There is no need to go into a state control versus local control discussion at the end of this presentation. The only question we need to concern ourselves with is whether or not capital outlay financing, like current operating expense financing, is headed in the direction of the state and away from the local school district.

A total of 18 states now have more income coming from the state level than from the local level. This is considerably higher than the number reported a decade ago. The trend has been clear for longer than that – less local and more state.

The thought must remain, however, that such an impetus does not spell the end for the general obligation bond. It simply will change the source of its issue from the local school to the state. Perhaps this is not a bad idea.